SENATE TAXATION
EXHIBIT NO. 4
DATE 1.19.11
BILL NO. SB94

Bloomberg

U.S. Companies Dodge $60 Billion in Taxes With Global Odyssey

By Jesse Drucker - May 13, 2010

Tyler Hurst swiped his debit card at a Walgreens pharmacy in central Phoenix and kicked off an international odyssey of corporate tax avoidance.

Hurst went home with an amber bottle of Lexapro, the world's third-best selling antidepressant. The profits from his $99 purchase began a 9,400-mile journey that would lead across the Atlantic Ocean and more than halfway back again, to a grassy industrial park in Dublin, a glass skyscraper in Amsterdam and a law office in Bermuda surrounded by palm trees.

While Forest Laboratories Inc., the medicine's maker, sells Lexapro only in the U.S., the voyage ensures most of its profits aren't taxed there -- and they face little tax anywhere else. Forest cut its U.S. tax bill by more than a third last year with a technique known as transfer pricing, a method that carves an estimated $60 billion a year from the U.S. Treasury as it combines tax planning and alchemy. (See an interactive graphic on Forest's tax strategy here.)

Transfer pricing lets companies such as Forest, Oracle Corp., Eli Lilly & Co. and Pfizer Inc., legally avoid some income taxes by converting sales in one country to profits in another -- on paper only, and often in places where they have few employees or actual sales.

After an economic bailout in which the U.S. government lent, spent or guaranteed as much as $12.8 trillion, the Obama administration faces a projected budget deficit of $1.5 trillion this year. In February, the administration said it would target some of the techniques companies use to shift profits offshore -- part of a package intended to raise $12 billion a year over the coming decade.

Losing $60 Billion

That's only about a fifth of the $60 billion in annual U.S. tax revenue lost to thousands of companies' income shifting, according to a study published in December in the National Tax Journal by Kimberly A. Clausing, an economics professor at Reed College in Portland, Oregon.

The lost revenue could pay the federal government's share of health coverage for more than 10 million uninsured Americans, such as Hurst -- more than a third of the people who will gain insurance under the health-care overhaul passed in March. The administration's proposed tax on certain financial institutions would take almost seven years to generate $60 billion.

"Transfer pricing is the corporate equivalent of the secret offshore accounts of individual tax dodgers," said Sen. Carl Levin, a Michigan Democrat and chairman of the Senate's Permanent Subcommittee on Investigations, in a statement to Bloomberg News. Levin has overseen hearings on tax shelters including those sold to wealthy people by KPMG LLP. "Now that progress has been made in addressing offshore tax abuse by individuals, transfer pricing is an issue that deserves scrutiny."

Tea Party Signs

The anti-tax activists of the national Tea Party movement haven't put transfer pricing on signs in their demonstrations, yet it deserves attention, said Mark Skoda, chairman and founder of the Memphis Tea Party.

"I find the issue of corporations paying no tax or little tax in the United States, when the majority of their operations are here, problematic," Skoda said in an interview. "The problem is that this is sort of the level of micro that people don't look at."

The trek taken by Forest's profits on Hurst's $99 purchase involves a corporate structure nicknamed "the Double Irish," registered offices that occupy no real estate and a set of U.S. rules that one tax attorney calls "unenforceable." It provides a case study in how U.S. companies use transfer pricing to avoid paying taxes.

'Seems Ridiculous'

"The fact the profits aren't reported in the U.S. seems ridiculous," said Hurst, 30, a self-employed marketing consultant, after hearing about the journey his money was undertaking. He began using Lexapro to counteract years of mood swings, including depression and anxiety he started experiencing in college, he said.

On April 15, the deadline for Americans to file their personal tax returns, the Internal Revenue Service said it would add new agents, attorneys and economists to ensure companies are following the rules for transfer pricing. The United Nations set up a panel in October to devise guidelines for the practice in developing countries.

"If multinationals cannot be prevented from shifting profits to low-tax jurisdictions, then it becomes impossible to maintain the domestic corporate tax base," said Reuven S. Avi- Yonah, director of the international tax program at the University of Michigan Law School in Ann Arbor. If that bleeding can't be stanched, "we might as well abandon the income tax."

$1 Trillion Offshore

U.S. companies amassed at least $1 trillion in foreign profits not taxed in the U.S. as of the end of last year, according to data compiled by Bloomberg. That cumulative total, based on filings by 135 companies, increased 70 percent over three years, from $590 billion in 2006.

While some of the offshore earnings reflect sales abroad, much of the growth results from expanding use of transfer pricing, said Martin Sullivan, a tax economist who formerly worked for the Treasury Department and Arthur Andersen LLP.

The system allows for creating paper transactions between subsidiaries of the same company to allocate expenses and profits to selected countries. For instance, when technology firms license their patents to offshore subsidiaries in low-tax countries, profits from sales overseas are booked to the foreign units, not the U.S. parents. The tax savings add to profits.

"A very significant part of this accumulation of profits offshore is the artificial shifting of profits using transfer pricing," said Sullivan, now a contributing editor to the trade publication Tax Notes. "There's been a significant increase in its aggressiveness over the past decade."

Like Churchill Said

Criticisms of transfer pricing "remind me of what Churchill said about democracy: It's the worst system -- except for all the others," said Karl L. Kellar, a partner at Jones Day in Washington, who advises companies on their taxes and who formerly worked for the IRS and the U.S. Justice Department.

Companies try to extract as much tax benefit as possible from transfer pricing to protect shareholders' interests, proponents say, particularly in the U.S., which imposes one of the world's highest tax rates on corporate income, 35 percent.

Frank J. Murdolo, Forest's vice president of investor relations, declined to comment on the company's tax planning.

The Journey Begins

It's about 2,100 miles from the Phoenix Walgreens, operated by Walgreen Co., to Forest's corporate headquarters on Third Avenue in New York. There, Howard Solomon, the drugmaker's chief executive officer, became interested in treating mood disorders as he watched his son, writer Andrew Solomon, struggle with depression in the 1990s.

He led Forest to Lexapro, whose sales last year ranked behind only Pfizer's Effexor and Eli Lilly's

Cymbalta among antidepressants, according to IMS Health Inc., a health-care data provider in Norwalk, Connecticut. Since its 2002 debut, Lexapro has generated $13.8 billion in sales, according to Gary Nachman, an analyst for Leerink Swann LLC, in New York. The drug accounted for 58 percent of Forest's sales for the fiscal year that ended March 31.

Forest declined to discuss how much it received from the $99 that Hurst paid for his Lexapro. For top-selling prescription drugs, the retailer would keep about $12, and $2 would go to a drug wholesaler, according to Helene Wolk, a health-care distribution analyst at Sanford C. Bernstein & Co. in New York. While the amounts differ for purchases covered by health insurance, the proportions are similar, Wolk said.

To Ireland

Of the $85 left for Forest, most doesn't stay on Third Avenue for long. It heads first to Ireland, where workers in lab coats and goggles make and test the medicine in a low-slung, off-white factory near a soccer pitch on Dublin's north side. A rock the size of a Smart car rests beside the parking lot, inscribed with one word in bright blue letters: "Forest."

This subsidiary, called Forest Laboratories Ireland Ltd., sells Lexapro to its U.S. parent, according to Dan L. Goldwasser, a Forest board member and an attorney with Vedder Price PC in New York.

That transaction is at the heart of transfer pricing: With each tablet Forest buys from the Irish unit, it shifts profits to Ireland, where corporate income is taxed at rates between 10 percent and 12.5 percent, compared with 35 percent in the U.S.

"Part of the object is to generate some of the profit in Ireland," Goldwasser said.

Undisclosed Price

The company won't disclose what it pays the Irish subsidiary for Lexapro or other medications made there. Tax accounting analysts say they can't calculate the pill's precise price either.

Overall, Forest's Irish operations, which employ about 5 percent of its 5,200 workers, reported $2.5 billion in sales during fiscal 2009, the most recent year for which figures are available. That equals about 70 percent of the parent company's $3.6 billion in net sales. Lexapro alone generated $2.3 billion in revenue in 2009, according to company filings.

Scores of U.S. pharmaceutical and technology companies have set up similar operations in Ireland, lured by an educated workforce, political stability and access to European markets, as well as low taxes, said Alan Mahon, a spokesman for the Irish Department of Finance.

"Ireland's 12.5 percent corporation tax rate has become an international 'brand,'" he said.

Exporting Intellectual Property

U.S. tax laws have sought to regulate transfer pricing in various forms since 1921. Treasury Department regulations in 1968 created standards for pricing inter-company transactions. Thousands of pages of rules have followed, and the tax code was amended in 1986 because of concerns that companies were shifting profits from the U.S.

For U.S. regulators, the key questions in transfer pricing are whether the parent pays too much to its offshore subsidiary or whether the subsidiary pays too little to its U.S. parent. Treasury Department regulations require "arm's length" prices, or the amounts that would be paid between unrelated parties.

Those rules are "based on a fiction," said Michael C. Durst, special counsel at Steptoe & Johnson LLP, in Washington, who advised companies on transfer pricing for 15 years and has emerged as a leading critic of the system.

Many of the transfer pricing transactions between a U.S. parent and its offshore units would never take place between unrelated parties, Durst said. So it's often impossible to compare the prices paid in those deals to prices in real-world transactions between separate companies, he said.

'Unbelievable Scandal'

"As a result of resting on this basic fallacy, transfer pricing rules have for many years been unenforceable," said Durst, who formerly worked for PricewaterhouseCoopers LLP and the IRS.

U.S. Sen. Byron Dorgan, a North Dakota Democrat, calls transfer pricing "an unbelievable scandal." He favors scrapping the rules in favor of a system that allocates profits as most U.S. states with a corporate income tax do. That method is based on factors including sales, number of employees and property in a particular state. Enforcement of the current rules is "impossible to do," he said.

"It's the equivalent of asking the Internal Revenue Service to connect the ends of two different plates of spaghetti," Dorgan said.

Forest derived the undisclosed price that it pays its Irish unit for Lexapro from a 2001 arrangement the parent company struck with Daiichi Sankyo Co., Japan's third-largest drugmaker, according to Goldwasser, the board member. That deal was to co- promote the hypertension medication Benicar, he said.

'That's Life'

"You're attributing to Forest Ireland more bargaining power than probably it actually had, but, you know, that's life," Goldwasser said.

A crucial step in calculating where a drugmaker's profits belong under transfer pricing is determining who owns a drug's patents for tax purposes, said Durst, the corporate tax attorney. While Forest's Irish subsidiary controls Lexapro's patents for the U.S. market, it didn't come up with the formula. Forest licenses the use of those patents from H. Lundbeck A/S, a Danish pharmaceutical company. The Irish unit paid for the drug's U.S. clinical trials, Goldwasser said.

The IRS claimed in 2007 that Forest didn't adequately value its U.S. marketing operations, allocating too much in profit to its Irish subsidiary, according to a person familiar with the matter. That person asked not to be identified because he wasn't authorized to discuss it publicly. The dispute involved profits from another antidepressant, Celexa, in 2002 and 2003, according to the person and filings by Forest.

Rival Economists

Such disagreements sometimes grow to involve hundreds of pages of studies by rival economists over comparatively small differences in costs that cumulatively add up to hundreds of millions of dollars. GlaxoSmithKline PLC, the U.K.'s largest drugmaker, settled a transfer pricing case with the U.S. in 2006 for $3.4 billion. Since December, the U.S. has lost two court cases with Silicon Valley companies: a $24.3 million dispute with Xilinx Inc., a programmable chipmaker, and a $545 million case with Symantec Corp., a software company.

In Forest's case, the IRS sought an additional $206.7 million in tax, according to the company's disclosures. Forest said in November it agreed to pay an undisclosed amount that "did not have a material impact" on its results.

Beginning in 2005, the company found a way to reduce its taxes even further by sending most of its Lexapro profits from Ireland to Bermuda.

'The Double Irish'

On advice from Ernst & Young, Forest Laboratories Ireland reorganized that year, dropping the country from its name. The newly dubbed Forest Laboratories Holdings Ltd. established a registered office in Hamilton, Bermuda, declaring the island its tax residence. This unit took control of licensing the patents.

A second subsidiary in Ireland inherited the old name. It handled the manufacturing, sublicensing the rights to the patents, according to a corporate disclosure and an internal Forest flow chart tracing the arrangement that was reviewed by Bloomberg.

The change helped the Irish subsidiary cut its effective tax rate to 2.4 percent from 10.3 percent the year before the reorganization, according to its annual reports. It did so by deducting from its taxable income the fees that went to Bermuda, which has no corporate income tax. Charlie Perkins, a spokesman for Ernst & Young, one of the so-called Big Four accounting firms, declined to comment on its work for Forest.

International tax planners have a nickname for the type of structure the drugmaker adopted: the Double Irish.

"Double Irish More than Doubles the Tax Savings," was the headline in a 2007 issue of the trade publication International Securitization & Finance Report over an article describing the model by a pair of U.S. tax attorneys, Joseph B. Darby III and Kelsey Lemaster.

Layover in Amsterdam

Ireland faces its own budget gap after real estate values collapsed. The deficit, pegged at 14.3 percent of gross domestic product last year, represented the biggest shortfall of any member of the 27-nation European Union, according to data released in April by Eurostat, the statistics office of the EU.

To avoid another Irish tax, Forest's profits don't fly direct to Bermuda. They have a layover in Amsterdam.

Fees paid to the Bermuda unit pass through yet another subsidiary, Forest Finance BV in the Netherlands, according to the internal Forest document, Dutch corporate records and a person familiar with the transaction.

That route bypasses a 20 percent Irish withholding tax on certain royalties for patents, according to Richard Murphy, a U.K. accountant who worked on similar transactions and is director of Tax Research LLP. The structure takes advantage of an exemption from the levy if payments go to a company in another EU member state, Murphy said.

Passing Through

Forest established its Dutch company in July 2005, two months before its Irish subsidiary got permission from Bermuda regulators to conduct business. The Amsterdam unit operates largely as a conduit, records show. In 2007, Forest Finance collected $1.19 billion in licensing income and paid out 99.6 percent of it in licensing expense, according to its annual report.

The Dutch company lists its office at an Amsterdam building used by Fortis Bank Nederland NV, the lender nationalized in 2008 by the Dutch government. Forest has no employees there, said a receptionist at Intertrust Group Holding SA, a business that manages financial records for companies. The receptionist wouldn't give her name. Intertrust was sold in January by Fortis Bank to a private equity firm.

The Dutch Channel

The Netherlands has more than 13,000 such entities "established by foreign multinational corporations for the purpose of channeling financial assets from one country to another," according to published research by the Dutch Central Bank. More than 12.3 trillion euros ($15.5 trillion) flowed in and out of them during 2008, the Dutch Central Bank said.

Forest's income tax savings from international operations almost doubled after its Irish-Dutch-Bermudan reorganization took hold. In fiscal year 2007, the company's effective tax rate dropped by 21.8 percentage points, or $155 million, because of the effect of foreign operations, according to U.S. securities filings. In 2009, the international tax benefit lopped 18.9 percentage points, or $183 million, off Forest's income tax bill.

International tax benefits boosted Forest's net income in 2009 by 31 percent, according to an analysis of its tax footnotes by Robert Willens, president of Robert Willens LLC, a consulting firm that advises investors on tax issues.

'Place of Business'

Even though Forest described its Bermuda office as the Irish subsidiary's "principal place of business" in a 2008 court filing, it has no employees on the island. The closest it comes to an actual presence is its registered office at Milner House, at 18 Parliament Street in Hamilton, a beige building nestled among the pastel structures of the island's main commercial area.

There, Coson Corporate Services Limited, part of law firm Cox Hallett Wilkinson, provides "corporate administrative services" for Forest Laboratories Holdings, according to Jeannette Monk, who identified herself as the company's corporate administrator. Asked whether Forest had any employees there, she said, "This is a law firm."

It's also the last port of call for about two-thirds of the profits Forest derived from sales of Lexapro and its other drugs in 2009. U.S. corporations can avoid taxes on such overseas profits indefinitely, until they decide to bring the earnings back home.

The Bottom Line

Unlike most deferred taxes, future levies on most foreign earnings don't count against income in reports to shareholders, said Michelle Hanlon, an associate professor of accounting at the Massachusetts Institute of Technology's Sloan School of Management.

So lower taxes from earnings kept overseas go straight to the bottom line, she said, and U.S. companies rarely repatriate significant portions of that income. They're permitted to use it in overseas operations or certain investments, or to let it sit as cash in bank accounts, Hanlon said.

An exception came in 2004 when Congress enacted a one-time break allowing companies to bring back their earnings at an effective tax rate of 5.25 percent, less than one-sixth the top corporate rate. As a result, 843 corporations brought $362 billion to the U.S., with $312 billion qualifying for the tax break, according to the IRS. Forest returned $1.2 billion to the U.S. under the legislation.

While it remains offshore and shielded from federal income taxes, most of the $1 trillion in foreign profits for U.S. multinationals cannot be used in the U.S. That doesn't make Tyler Hurst very happy about his Lexapro transaction.

"If I'm purchasing it from Walgreens two blocks away, that money isn't going to anything local, or anything national," he said. "I'm giving my money to Ireland."

To contact the reporter on this story: Jesse Drucker in New York at jdrucker4@bloomberg.net.